

October 18, 2005

HONORABLE MAYOR AND CITY COUNCIL:

In preparing the 2005-2006 Adopted Operating Budget for the City of San José, the Administration faced a fourth year of budget reductions — an unprecedented challenge made more daunting by the lack of evidence that an economic recovery is approaching. The regional economic decline that began in early 2001 has sustained itself far longer and with greater severity than predicted. The unavoidable truth now is that budget actions made in the current environment must be viewed in the context of an enduring fiscal problem with little sign of relief in the near future.

As we enter the fourth year of declining budgets, it is extraordinary that to date the organization has been able to avoid more serious reductions. We have effectively managed our way through the most sustained and challenging funding shortfall in recent memory — far worse than the early '90s. At the foundation of that continuing effort has been the conservative fiscal policies to which the City Council has committed itself and the organization. Building on this foundation, our employees have responded by partnering with the City Administration to help keep costs down. Every non-public safety bargaining unit joined the City's management team this fiscal year in foregoing pay increases to lighten the impact of funding shortages.

Because San José is a City that has built a well-earned reputation for high quality service delivery, the most difficult decisions we faced are those that resulted in a negative impact to those services. There is not one service that we provide, for which there is not a committed constituency that relies on them. In this Adopted Operating Budget, the City Council made a series of difficult decisions. In recent years, we have bridged our deficits by trimming rather than eliminating services. We have asked our employees to be more productive and our managers to be more creative, so that our residents would be spared more serious impacts. In this 2005-2006 Adopted Operating Budget, there are severe and unavoidable service reductions. The strategic use of one-time dollars to bridge funding gaps in ongoing programs was maximized. A freeze in all but the most essential hiring — an approach that preserves vacancies to avoid lay-offs when services are reduced or eliminated — has the effect of reducing our ability to deliver the services. Yet this strategy, too, was maximized.

2005-2006 ADOPTED BUDGET MESSAGE

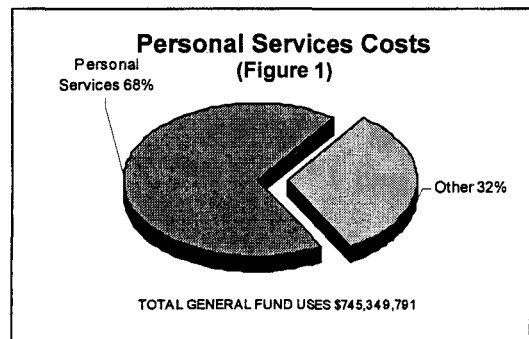
Despite the fiscal challenges, the actions in this Adopted Operating Budget focused on City Council priorities, directing resources toward essential services, basic infrastructure requirements, economic development opportunities, and maintaining the City's strong commitment to neighborhoods. City Service Areas (CSAs) continue to focus resources on core functions, ensuring the ability to continue providing high quality services even as we reduce services provided. Efforts to restructure how we deliver services to ensure that we use our resources as effectively as possible are more prominent than ever. Finally, in an effort to ensure cost recovery, some fee increases were approved.

As in years past, reductions are divided between Tier One actions consisting of budget decisions to be implemented immediately and Tier Two proposals that would be implemented only if expenditures increase beyond those assumed in this current budget. The 2005-2006 Adopted Operating Budget addressed another revenue reduction caused by State action. In this case, we are in the 2nd year of the agreement worked out between the State and local governments under which the State takes another \$11.1 million of our local property tax dollars. However, with the passage of Proposition 1A on the November 2004 ballot, future revenue reductions imposed by the State have been restricted, reducing this ongoing threat to the City's long term revenue picture.

Similar to last year, new cost control strategies and operational adjustments were implemented to reduce the scale of service reductions that would otherwise be required to balance the 2005-2006 Operating Budget. Once again, Tier Two waits in the wings, a set of much more severe reductions that would be necessary to pay for any expenditure increases that result from arbitration or negotiated settlement with our Public Safety bargaining units. Tier Two, also known as the *2005-2006 Compensation Impact Contingency Plan*, can be found in a separate section in this document.

With each year of continued budget reductions, certain strategies become less effective. While we have continued the current hiring freeze to maintain vacancies and reduce expenditures, fewer of these vacancies are in positions that match the skills of displaced employees. We again included the use of one-time funding and reserves, but these opportunities are dwindling. Also, unlike previous years when we successfully trimmed programs to soften the community impact, visible service reductions will result from this adopted budget.

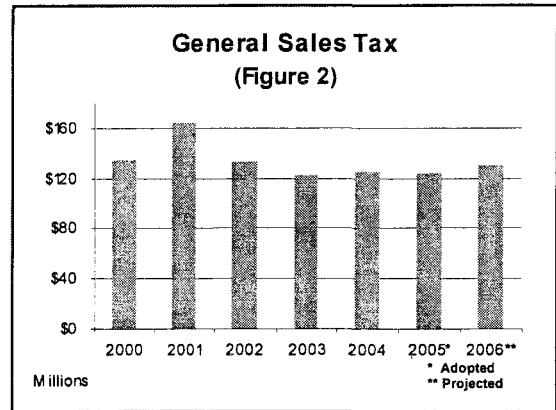
Unfortunately, San José continues to confront a structural fiscal problem in the General Fund. Expenditures exceed revenues by a significant amount. As the Personal Services Costs chart shows (Figure 1) more than 2/3rds of these costs (68% in 2005-2006) are directly tied to personnel costs. With financial forecasts



for the local economy continuing to display few signs of improvement, the 2005-2006 Adopted Operating Budget assumes that there will be only minor growth in economically sensitive revenue sources next year. A number of expenditure management actions implemented in past years will continue. Total General Fund revenue projections in the 2004-2005 Operating Budget were \$656.2 million, and for 2005-2006 current projections place the base budget revenues number at \$640.9 million (not counting revenue generating actions included in the 2005-2006 General Fund balancing strategy). While the full significance of the economic downturn is detailed in the *General Fund Balancing Strategy Detail* (Attachment A), some noteworthy trends are highlighted here. If there is any good news on the horizon, it is that the deterioration in our revenues appears to have leveled off — an indication that while a recovery is not yet in sight, the downward slide has apparently bottomed

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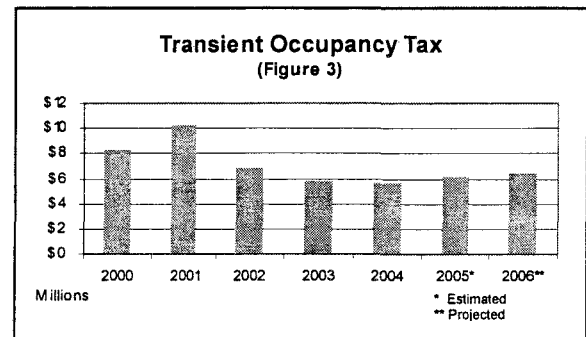
out. For the first time in four years, some economically sensitive revenue sources are above our projections. General Sales Tax revenue (Figure 2) is showing a small increase, as is Transient Occupancy Tax (TOT) (Figure 3), which is tied to revenue from local hotel bookings. TOT revenues were projected to grow by 2% in 2004-2005 to \$5.8 million, but are now projected to reach \$6.2 million—the result of an increase in the number of hotel rooms in San José and an increase in the number of room nights sold. Occupancy rates at local hotels, however, remain well below peak levels.



It is significant that San José has continued to receive a strong AA+ bond rating through the sustained downturn. Our rating continues to be the highest of any major California city. This sound fiscal report card helps San José balance its budget by keeping the interest rates low when we borrow money. Actions within this approved budget will draw down the City's reserve funds significantly. With the City Council's generally conservative fiscal policies in place, we believe this approach is both prudent and necessary. However, further reliance on the utilization of reserves must be resisted. The revenue estimates included in this budget presume that the local economy in 2005-2006 would show only minimal growth in our economically sensitive revenue sources.

Although there are now stronger indications of a recovery at the State and national levels, clear signals of significant improvement in our local economy are not on the horizon. Until we see sustained growth in jobs, we are presuming that the local economy would remain stagnant and our revenue growth relatively flat.

ECONOMIC OVERVIEW



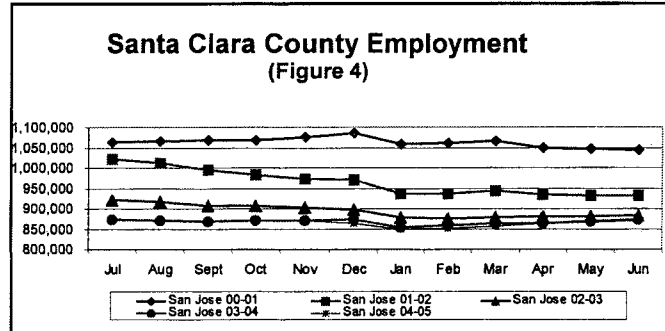
A significant challenge in formulating the budget is projecting the future condition of the local economy. This has been a particularly difficult task given the mixed signals about the state of the economy. At the national level, what had appeared to be a recovering economy has shown inconsistent signs. The national economy is suffering from the effects of excessively large increases in oil prices combined with rising interest rates and stagnant wages for most workers. Investors are also increasingly nervous. The Dow Jones Industrial Average through June 2005 is down almost 5% since the beginning of the calendar year, and the NASDAQ is down 1.3%.

Locally, we have received some encouraging news regarding our Sales Tax. The first quarter 2005 receipts (October through December sales activity) experienced the largest increase in over three years, up 9.1% from the prior year level. The City's Sales Tax consultants, MBIA MuniServices, however, urge caution. A significant portion of this increase is related to a one-time correction for use tax on a large construction project that had previously been allocated to the Countywide Pool instead of directly to San José. Taking this adjustment into account, the quarterly Sales Tax receipts would represent positive growth of 3.0%.

2005-2006 ADOPTED BUDGET MESSAGE

Job Losses and Unemployment

As we have reported consistently, by far the most reliable indicator of future economic growth would be found in signs that our local companies are creating new jobs. Unfortunately, that is not the case. Growth in jobs in Santa Clara County remains stagnant (Figure 4). Through June 2005, the loss of local jobs in Santa Clara County has risen to 207,600 jobs since 2000. The most recent jobs reports continue to provide mixed news. The June employment report indicated that although local area jobs actually increased slightly (4,900 jobs) due, in part, to the seasonal increase in construction, the comparison over the past year (from June 2004) still shows a net loss of 1,800 jobs. Scott Anderson, Wells Fargo senior economist, puts the local jobs reports into perspective, saying, "San Jose is still the weak spot in the State. California's employment growth is running at about 1.9% year over year. San Jose isn't even close to that. It isn't even close to what's happening in the East Bay where you're seeing job growth close to 1%."



After increasing to 6.3% in February, the local unemployment rate fell to 5.6% by June, but this was still above the State average (5.4%) and the national average (5.2%). Many businesses in the valley are starting to see their profits rise, but they are doing it without hiring new staff. With oil prices continuing at high levels, consumer confidence waning, and continuing fluctuation in the stock market, the prospect for firms to start hiring do not appear to be very high. Although we are still experiencing year-over-year job losses, they are lower than the past and some months are actually showing gains, albeit small ones, that hopefully portend better things to come. In the near-term, however, there is no sign of an imminent increase in hiring patterns over the next twelve to eighteen months, and we still have a lot of ground to make up when the job growth finally appears.

In summary, the economic situation remains stable, but with no indication of significant improvement. Local job growth projections continue to be dismal, steadily rising gasoline prices threaten to impact consumer spending, and there is growing concern that the warnings that California housing prices are unsustainable will prove to be accurate. As a result, the 2005-2006 General Fund revenue estimates have presumed flat or slight growth in key City revenues.

State Budget Problems

The State of California continues to face significant budget problems. With the passage of Proposition 1A, the State impact on the City has become a little more predictable, but no less severe in the near term. The largest State impact for 2005-2006 is once again the \$11.1 million required payment to the State that the City must make for the second year in a row. This is San José's portion of the \$1.3 billion cities were required to pay to the State in both 2004-2005 and 2005-2006 in return for the State's support of Proposition 1A. Other State actions implemented last year continue to affect the City's cash flow and earnings. Under these actions, Sales Tax cash receipts the City received monthly in the past will now be received twice a year, resulting in lower overall average

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State Budget Problems (Cont'd.)

cash balances. The lower average cash balances will almost certainly result in lower investment earnings for the City.

The City is also impacted by past State actions related to reimbursements for state-mandated programs. In budget actions last year, the State Legislature continued the reimbursement received for the jail booking fees paid to the County for 2004-2005. However, they eliminated this reimbursement starting in 2005-2006 and limited the amount counties could charge cities for booking fees to one-half of their administrative costs. The elimination of the reimbursement will reduce City revenue by \$2.5 million in 2005-2006. It is still unclear whether there will be a commensurate reduction in the administrative costs that the County would attempt to impose on the City. Should the costs as determined by the County exceed half of last year's costs (as suggested in recent conversations with them) additional reductions to the Adopted Budget will be required.

BUDGET OVERVIEW

In the 2005-2006 Adopted Operating Budget, the total net approved funding is \$2,664,525,571 for all City funds (General, Special, and Capital). This is \$30,949,279 or 1.1% lower than the 2004-2005 Adopted Operating Budget (Table 1 below). The total number of positions decreased by approximately 1.7%, to a total of 6,672 — the third year of significant position reductions.

2005-2006 ADOPTED BUDGET — ALL FUNDS (Table 1)			
	2004-2005 Adopted	2005-2006 Adopted	% Change
General Fund	\$ 812,528,785	\$ 841,688,233	3.6%
Special Funds	1,275,401,267	1,228,838,694	(3.7%)
<Less: Operating Transfers>	(616,705,061)	(567,501,127)	(8.0%)
Net Operating Funds	\$ 1,471,224,991	\$ 1,503,025,800	2.2%
Capital Funds	\$ 1,230,129,859	\$ 1,168,675,771	(5.0%)
<Less: Capital Transfers>	(5,880,000)	(7,176,000)	22.0%
Net Capital Funds	\$ 1,224,249,859	\$ 1,161,499,771	(5.1%)
Net Total	\$ 2,695,474,850	\$ 2,664,525,571	(1.1%)

The General Fund portion of the City's Budget increased by 3.6% from 2004-2005, and totaled \$841,688,233.

2005-2006 ADOPTED BUDGET MESSAGE

Budget Balancing Strategies

The reductions contained in this adopted budget must be viewed in the context of cuts already experienced by the organization. Since June 2003, we have overcome funding shortfalls totaling \$173.3 million dollars. In June 2003, the General Fund gap was \$81.3 million with an additional \$10.8 million caused by State budget decisions added two months later. Last year's challenge began with a \$69.8 million shortfall that was closed in June, followed by another \$11.4 million in August to close the shortfall caused by the first of two annual payments to the State.

Our earliest projections for 2005-2006 included a \$60.3 million shortfall more than half of which (\$31.7 million) resulted from the use of one-time dollars to balance the 2004-2005 Operating Budget. As we entered the fourth straight year of severe funding gaps, cost management controls that once seemed extraordinary were now integrated into the day-to-day operation of the City. As is clear from the savings achieved to date, these strategies have succeeded in softening the impacts of service reductions to our residents and our employees. A non-sworn hiring freeze first imposed in 2001 has also continued. Under the freeze, each request to fill a position is reviewed by the Budget Director and a Deputy City Manager. Expenditure controls first instituted in February 2003 continued on travel, meals, marketing, technology and vehicle purchases. The Voluntary Furlough/Reduced Work Week Program continued to bring new savings totaling \$467,000.

In October, the City Administration directed CSAs to make additional current year expenditures reductions totaling \$5.2 million, which translated to a 1% reduction for Public Safety and a 2% reduction for all other CSAs. Those savings produced from these reductions were placed in reserve and were approved to be utilized as part of the 2005-2006 balancing strategy. In February, the Five-Year Forecast showed a slightly improved picture, leading to a reduced shortfall in the 2005-2006 General Fund of \$56.9 million. Further refinement of revenue and expenditure projections resulted in a final General Fund shortfall in this Adopted Budget of \$58 million. With the continuing freeze on non-sworn hiring and the elimination of vacancies, the accumulated vacancy total in May stood at 465, down from 578 in May 2004. As was the case last year, the strategic use of reserves was approved as a part of the balancing solution. As directed by the City Council in approving the Mayor's March Budget Message, the Economic Uncertainty Reserve of \$10.4 million was used to lower the budget shortfall projected for 2005-2006.

In developing the 2005-2006 Adopted Operating Budget, the Administration once again focused City resources on vital core services and City Council priorities. Each CSA, including Public Safety, was required to propose reductions and revenue enhancements. In Tier One, reductions in Police and Fire were kept to a minimum in recognition of the City Council's expressed commitment to Public Safety, resulting in more severe service reductions in all other CSA's. With the bulk of Tier One reductions falling outside Public Safety, the inevitable result is that Public Safety reductions make up the largest component in the Tier Two 2005-2006 *Compensation Impact Contingency Plan*.

In preparing the 2005-2006 Adopted Operating Budget, the Administration was guided by the 15 principles presented in the City Manager's Budget Request that was approved by the City Council as part of the Mayor's March Budget Message. These are:

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Budget Balancing Principles (Table 2)

I. Balanced Budget

1. Balance the City's ability and capacity to continue providing essential services to the community, revive the economy, build strong neighborhoods, and stabilize the City's budget.
2. Mitigate to the extent possible direct service reductions by utilizing a combination of ongoing expenditure reductions and ongoing revenue sources, coupled with one-time expenditure cuts, one-time revenues, and/or a portion of the reserves designated for budget balancing purposes.
3. In addition to strategies that achieve efficiencies and appropriate cost savings, utilize fee increases to assure that operating costs are fully covered by fee revenue. Revisit the fees and charges structure to implement revisions that would charge non-residents a premium for our services and discourage "abusers" of services.
4. Explore opportunities to establish new fees for services where appropriate.
5. Continue with the elements of the current capital improvement plan that keeps money flowing to our economy. In addition, however, bring forward recommendations for further deferral of capital improvement program schedules for projects that create negative impacts on the General Fund.

II. Satisfied Customers

6. Defer consideration of any new program commitments and initiatives, unless those program commitments stimulate the local economy and job creation and/or are funded through redeployment of existing resources and/or until economic recovery occurs.
7. Focus on protecting vital core City services. Focus service reductions first in those areas that are least essential.
8. Emphasize quality over quantity: do fewer things as required, but do them well.
9. Consider alternative service delivery mechanisms (e.g., appropriate community partnerships, public-private partnerships, working with other jurisdictions to ensure no service overlap, outsourcing/insourcing services delivered by City staff, etc.).
10. Emphasize performance by focusing on improving employee productivity and continuously improving business practices, including streamlining, innovating, and simplifying City operations.

III. Engaged Employees

11. Continue to make employee involvement a priority for CSA budget balancing idea development.
12. Ensure that an active budget communication plan with City employees is in place and utilized.
13. Balance proposed reductions across the organization and employee groups, including a careful review of all non-essential overtime and non-personal/equipment expenses.
14. Make every effort to eliminate vacant positions, rather than filled positions.
15. Work together with employee bargaining groups to find ways to limit the number of employee layoffs.

2005-2006 ADOPTED BUDGET MESSAGE

Budget Balancing Strategies (Cont'd.)

The resulting 2005-2006 Adopted Operating Budget includes a combination of ongoing cost reductions, prudent fee increases, and the strategic use of reserves and one-time revenues. Although on the revenue side, a search for new revenue sources or significant opportunities to recover costs through fees produced limited new funds, the use of reserves and other one-time revenue sources accounted for well over half of the total balancing actions. The table below shows the matrix of Tier One balancing strategies and the dollars associated with each action.

Tier One General Fund Budget Balancing Plan (Table 3)	
SOURCE OF FUNDS	(In \$000s)
2005-2006 Future Deficit Reserve (one-time)	12,541
Cardroom Revenue (one-time)	8,500
Economic Uncertainty Reserve (one-time)	10,436
Enhanced Park Maintenance Reserve	1,000
Business Tax Amnesty	1,000
Transfer from Other Funds	3,602
Miscellaneous	6,702
Total Revenue & Reserve Solutions	43,781
USE OF FUNDS	
Position Eliminations/Efficiencies	(7,128)
Non-Personal/Equipment Reductions	(7,737)
Funding Shifts	(2,119)
Mayor, City Council and Appointees	(1,982)
Use of Reserves (Committed Adds)	(7,704)
Workers' Compensation Claims	(6,500)
New Facilities (Operations & Maintenance)	7,423
Salary Reserve	5,000
Miscellaneous	6,476
Total Expenditure Solutions	(14,271)
Total Balancing Solutions	58,052

The Full-Time Equivalent position (FTEs) reductions contained in this adopted budget action are shown below:

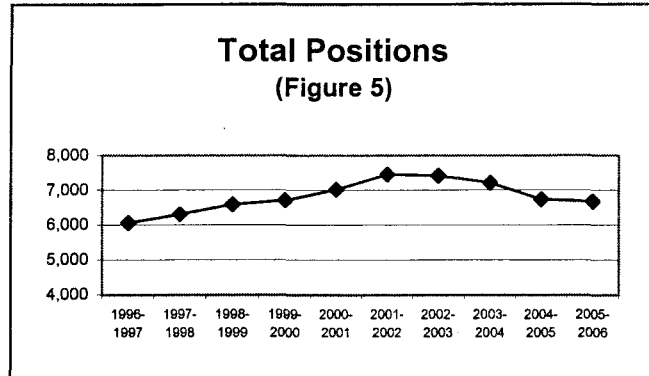
Position (FTE) Reduction Impacts (Table 4)	
Tier	FTEs Impacted*
Tier One	88.15
Tier Two	332.6
Total	420.75

**FTEs include both vacant and filled positions.*

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Budget Balancing Strategies (Cont'd.)

The approved reductions will affect all levels of the organization from management to front line workers as well as every CSA. These position reductions equal service reductions and represent difficult choices. Examples include a reduction in library hours, downsizing parks maintenance, and reductions in the Traffic CIP, landscape and pavement maintenance, traffic device maintenance, and City-reimbursed sidewalk repairs. In short, there were no good or easy choices this year. As Figure 5 demonstrates, the reductions imposed on the organization since 2002, have combined to reduce the City's total position count significantly, from the 2003-2004 Adopted Budget level of 7,213 down to 6,672 (a net reduction of 541) roughly equivalent to the number of positions in 1998-1999.



Similar to last year's budget proposal, the 2005-2006 Adopted Operating Budget was balanced with assumptions about things that have yet to occur, but which once again could have significant impacts on this operating budget. Chief among these is the possibility of unanticipated compensation increases for our Public Safety employees whose contracts expired in February 2004. These employees have the right to binding arbitration. Because Public Safety represents 66% of the General Fund personal services expenditures, a 1% salary increase for sworn personnel would cost the City \$2.7 million annually. Consistent with the Council-approved Mayor's March Budget Message, reductions contained in the *2005-2006 Compensation Impact Contingency Plan* were not recommended for implementation as part of this budget. However, a review of this list makes it clear that these reductions, if implemented, would fall most heavily on the Public Safety CSA — the inevitable result of having held back the more serious Public Safety reductions in the Tier One decisions.

Fee & Rate Increases

In 2004-2005, a three-year effort to reach cost recovery levels through phased fee increases in the Development Fee Programs (Planning, Building, Public Works and Fire) paid off with increased financial stability and improved performance. When the popularity of last year's enhanced service options required additional staff to maintain customer service standards, funding was available to add two Plan Check Engineers in Building only because the program was at cost recovery. In response to industry groups support for the transition to cost recovery, the City committed: 1) that there would be no fee increases in 2005-2006; and, 2) that a Cost of Development Survey would be undertaken. In keeping with these commitments, no across the board development fee increases were included, with the exception of a cost recovery adjustment to the Fire Department's hourly rate. Instead, the development partners used a combination of resource cuts and reserve funds to offset anticipated increases in operating and regulatory costs. Fee increases will, however, need to be considered in 2006-2007 to avoid reductions in service. The first annual South Bay Area Cost of Development Survey was published in June 2004 and concluded that San José's development costs

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Fee and Rate Increases (Cont'd.)

rank in the middle to lower end when compared to six other local jurisdictions on five sample projects. The 2004-2005 survey results were released in July.

In the Environmental & Utilities Services CSA, a number of fee increases were approved. Approved utility rate increases will cover cost-of-living adjustments and improve neighborhood services. The first year of an approved three-year rate increase strategy will raise Storm Sewer Charge rates by 4.5%, amounting to approximately \$2 more annually for a single-family home. This will provide funding to meet regulatory requirements, operate the storm sewer system, and maintain a modest capital improvement program.

The second year of a three-year strategy initiated last year of 4.5% annual rate increases was approved for Sewer Service and Use Charge fees to address aging infrastructure needs, improve reliability in wet weather at the treatment plant, cover increased costs to operate and maintain the sewage collection and treatment systems, and ensure the fiscal integrity of the Sewer Service and Use Charge Fund. This will amount to an increase of \$10.68 annually for single-family homes.

A modest rate increase of 2.6% was approved for the Municipal Water System for 2005-2006 to provide funding for required maintenance and operations. This is the first general rate increase for Municipal Water System since 1992. More recent rate increases have been limited to covering the increased costs of purchasing wholesale water from San Francisco and the Valley Water District. The Municipal Water increase will amount to \$10.80 annually for the average residential household. The new rates will remain lower than those charged by the other two private water retailers that serve San José.

To recover contractual cost-of-living increases, primarily due to soaring fuel costs, a three-year rate strategy of increases up to 5% was proposed as part of the 2005-2006 Proposed Operating Budget. These increases have been deferred because of the Norcal Waste Systems of San Jose, Inc 2004 contract amendment. It is expected that these increases will be reconsidered by the City Council during the Mid-Year Budget Review process. For 2005-2006, an increase of 3% for single-family homes (SFD) and 2% for multi-family complexes was recommended. If approved and implemented, the monthly SFD rate for the average household (32 gallon bin) would increase from \$18.30 to \$18.90 in 2005-2006. Even with these increases, San José rates would remain below the Santa Clara County average.

City Service Areas

Careful readers would note that the City Manager's Budget Message uses new names for some City Services Areas, the structure within which our workforce and departments are organized. To strengthen and clarify reporting relationships between the CSAs and the City Manager's Office, CSA names will be changed in 2005-2006. With the exception of Transportation and Aviation Services, which will combine these previously separate CSAs, the change represents not so much a reorganization as a recognition that new names could more accurately reflect the work that is being accomplished by the partner departments within each CSA. The new CSA names will be: 1) Community and Economic Development; 2) Environmental and Utility Services; 3) Neighborhood

2005-2006 ADOPTED BUDGET MESSAGE

City Service Areas (Cont'd.)

Services; 4) Public Safety; 5) Strategic Support; and, 6) Transportation and Airport Services. Within the 2005-2006 Adopted Operating Budget, the new CSA names are used in this message as a means of introducing the coming changes. However, for continuity with previous budgets, the current CSA names are maintained throughout the rest of the document.

Community and Economic Development (Economic and Neighborhood Development)

With the flat local economy constraining the City's ability to deliver services, it is appropriate that the adjustments for the Community and Economic Development CSA emphasize aggressive implementation of the City's Economic Development Strategy. The following initiatives focus on priorities identified by the City Council:

- Attract and retain retail business to provide San José residents with more convenient services and help overcome San José's high retail leakage to other communities;
- Communicate a compelling community identity to raise the image of San José as a destination;
- Facilitate job and revenue generating company expansions and relocations to provide the City with a competitive edge as the local economy begins to recover;
- Encourage sporting teams, events and facilities to bring additional tourism money to San José; and
- Expand efforts on Council priorities - museum/cultural growth, interface with San José State University, attraction and retention of businesses, and diversification of the economic base.

The approved addition of four temporary positions using one-time resources addresses several Economic Development initiatives. They will assist in: 1) raising the image of San José as a destination; 2) attracting additional retail business; 3) increasing tourism money by encouraging sporting teams, events and facilities to locate in San José; and, 4) supporting development facilitation. It is believed these positions will generate additional revenue to justify their continuation on a permanent basis. A decision on whether to recommend continuation of these positions will be made as part of next year's budget process.

As directed by the City Council, local small business chambers of commerce and the Convention and Visitors Bureau support has been reduced by 8.2%, matching the average reduction of all General Fund non-Public Safety CSAs. In addition, the City's contribution to the Arena Authority is cut by \$49,000, while its asset management responsibilities will be broadened to include other facilities, which drive local economic activity. Oversight of the Authority will be moved to the Office of Economic Development.

The Silicon Valley Workforce Investment Network (SVWIN) program will experience a \$1.1 million reduction in federal funds this year. The program will continue to offer universal services to its clients, however, services that address the needs of workers displaced by companies that downsize will be reduced. While downsizing has been a significant issue in the past few years, the rate of job eliminations is flattening out.

2005-2006 ADOPTED BUDGET MESSAGE

Community and Economic Development (Economic and Neighborhood Development) (Cont'd.)

Under adjustments in the area of code enforcement, over 90% of the Community Code Enforcement inspection staff will be supported by special funding sources (Community Development Block Grant Fund, Redevelopment and Solid Waste and Multiple Housing fees). General Code Enforcement activities will shift from proactive enforcement to a more reactive model redirecting efforts toward life safety complaints and conditions. This reduction will save the General Fund \$278,000. Code Enforcement's "Driveway Team", a proactive enforcement unit will continue to reduce blight within Strong Neighborhood Initiatives (SNI) areas.

Several balancing strategies were reflected in this budget, including staffing reductions and redeployments that will effectively mean a reduction in service within the Special Projects and SNI teams in the Planning Services Division. Land use and planning actions to further the goals of the adopted SNI plans and specific plans will be undertaken. The approved addition of a Planner to review urban runoff regulations will address the increased demands of implementing storm water permit provisions for new and redevelopment projects.

Neighborhood Services (Recreation and Cultural Services)

The Neighborhood Services CSA strives to serve, foster, and strengthen community by providing access to lifelong learning and opportunities for enjoyment. Partnerships have always existed among the City, its partners who serve the neighborhoods, and the communities that make up our neighborhoods. Strategies to maintain programs in the face of significant reductions require collaboration, partnership, leveraging resources and building community capacity for self-reliance. Where service reductions occur we have tried to ensure that, although the quantity of programs may be reduced, the quality of our remaining programs is sustained.

With a work force already reduced last year by 252 positions, the Neighborhood Services CSA has carefully assessed priorities and made difficult choices in recommending service reductions. Over the next two years, it is anticipated that we will be able to support only critical core services that preserve and provide clean and safe parks, provide a safe environment for youth and seniors, and protect the public infrastructure. Meeting these core service needs will require program consolidation, service adjustments, greater reliance on cost recovery, and community-based organizational support and neighborhood civic engagement.

The Library continues to provide services to promote reading, adult and family literacy, lifelong learning and school readiness at all library facilities. The adopted budget reflects a change of service hours at branches from 51 hours per week to 47 hours per week for nine branches, and an "open daily" service plan of 51 hours per week at seven branches to be implemented in fall, 2005. For the seven geographically-distributed branches that will be open daily, the change will reduce Monday services to five hours from 2 pm to 7 pm and add Sunday hours from 1 pm to 5 pm. The adopted budget will also reduce service point coverage hours provided in children's, teen and adult services, reference, and language/media areas at the Dr. Martin Luther King, Jr. Library.

The City currently operates 42 community, satellite, and neighborhood centers with a staff of 75. During the coming year five new community centers will open. Because the current economic

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Neighborhood Services (Recreation and Cultural Services) (Cont'd.)

environment constrains the City's ability to add staff, the new centers can only be operated with employees from older facilities that will be closed. Staff submitted to the City Council in May a detailed facility re-use strategy in May that identifies alternative programming options for these older facilities. Approximately one-half of the community centers are being considered for alternative programming possibilities between 2005-2006 and 2008-2009. Community-based organizations will be recruited through a competitive process in order to provide neighborhood and community services. In some cases, Parks Maintenance may work out of these facilities. Only if no suitable tenant can be found would centers be considered for closure. This consolidation and reduction in service will allow new and recently renovated facilities to open while generating nearly \$600,000 in operating savings to the City. The focus of programming that will be preserved will be on the critical core services that provide a safe environment for youth, seniors and disabled populations.

In the area of park maintenance, the City currently maintains more than 3,700 acres at 194 separate park sites. The annual cost to maintain 144 neighborhood parks is \$12.6 million. Our fiscal reality does not allow these costs to be sustained. Under the approved cost reduction strategy, the number of days of park maintenance will be reduced, but park rangers and remaining maintenance staff will keep restrooms open on days when park maintenance does not occur. The current neighborhood park maintenance schedule will be reduced by two days, while regional park maintenance will drop to six days per week. In addition, watering cycles will be reduced. In addition, fees will be increased at Happy Hollow Park and Zoo. To accommodate the new park facilities opening in 2005-2006, these reductions will be partially offset by the addition of \$628,000 in new funding for maintenance and operations. Even with the addition, parks maintenance achieved a budget reduction of 21.61 positions totaling \$1.5 million in savings.

Approved program actions will reduce staffing levels in therapeutic services and the Office on Aging as well as aquatics, recreation, and the Neighborhood Development Center. Training, safety and youth employment will be consolidated. Also approved is initiation of an annual fee of \$25 for the City's summer drop-in programs, and a one-time reduction of \$100,000 in funding for the Future Teacher Loans. Other areas approved for reduction include a one-time reduction in the art venture fund program and a reorganization that moves Office of Cultural Affairs to the Office of Economic Development that will eliminate a deputy director position while adding a senior analyst.

The Strong Neighborhoods Initiative (SNI) is the core of the City's efforts to ascertain neighborhood priorities, deliver effective neighborhood services, and develop effective community leadership and partnerships with residents. In 2005-2006, there are no staffing changes in the Strong Neighborhoods program. Since its inception through this fiscal year, 40 top ten priority projects have been completed and 111 more are underway. The City, the Redevelopment Agency and the community have invested \$111 million over this time period. In the coming year, staff will be working to better integrate those providing community policing with the Mayor's Anti-Graffiti Task Force, as well as staff in Code Enforcement, Housing, PRNS, and the City Attorney's Office.

Finally, as directed by the City Council in approving the Mayor's March Budget Message, an 8.2% reduction (equal to the average of the reductions experienced by all of the City's non-Public Safety CSAs) will be applied to dollars that support our community based organization partners. This will result in a savings of approximately \$149,000.

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Neighborhood Services (Recreation and Cultural Services) (Cont'd.)

Safe schools remain a high priority, and budget adjustments focus on creating program efficiencies to minimize impacts to school and community security. There will continue to be eight Safe Schools Campus Initiative response teams, but the elimination of vacancies generates \$407,000 in savings. Teams will be housed in the community center "hubs" described above.

Though these are very difficult economic times and challenging budget decisions to make, the Neighborhood Services CSA has worked to creatively rethink City service delivery, build on and create new partnerships, and connect with residents and stakeholders to identify neighborhood priorities. The CSA continues to develop and improve capacity city-wide to enhance the receipt of grants and pursue revenue generation through corporate sponsorships. The evolving model of service delivery provides a solid foundation to build on and improve the delivery of recreation and cultural services to our community when additional funding again becomes available.

Strategic Support

The consolidated Strategic Support CSA is made up of Employee Services, Finance, General Services, Information Technology, Public Works, and Retirement Services. This CSA provides recruitment, training, purchasing, technology, revenue collections, facility and fleet maintenance services, maintains the organization's capital assets, administration of retirement benefits, and protects and invests the City's financial resources. These functions are critical to the ability of front-line departments to serve the community.

The capital program workload is expected to decrease for the second consecutive year. However, the City's unprecedented investment in capital projects in the last several years, made possible by three major voter-approved bond measures, coupled with the completion of the new City Hall, present a major resource challenge. The adopted budget eliminates 22 positions from the capital program, aligning resources with the reduced workload and producing \$1.85 million of savings. Maintenance of the new City Hall will be managed by a combination of new and existing positions. General Services positions from the existing City Hall will complement \$5.4 million in new General Fund support for 23 new maintenance and security positions.

In this fourth consecutive year of reductions, it is becoming increasingly difficult to retain delivery of even basic core services at the desired level. The CSA has identified opportunities to reorganize and share services that minimize, to the extent possible, the service impacts of these continuing reductions. Under this budget, Finance will assume Employee Services' timekeeping, accounts receivable and accounts payable functions with the elimination of the single clerical position that provides these services for a \$97,000 savings. During 2005-2006, additional opportunities will be identified to implement additional shared services within the new City Hall.

In the Department of Information Technology, a vacant deputy director position will be eliminated, while a second deputy director position will be reallocated as an assistant director to provide stronger oversight of day-to-day departmental operations, saving \$142,000. For most of 2004-2005, the department was under the stewardship of an Acting Director, who identified a number of other opportunities for organizational improvements that will be presented to a new Chief Information Officer who began in July.

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Strategic Support (Cont'd.)

In addition, the Strategic Support CSA will generate an estimated \$1 million in additional revenues by implementing a business tax amnesty program. It has been several years since the last program was undertaken, which yielded significant new ongoing revenues to the General Fund. An ongoing \$6.5 million reduction to the General Fund appropriation for workers' compensation claims was approved, reducing the fund from \$22 million to \$15.5 million. This reduction is possible due to lower than anticipated claims costs and recent changes in workers' compensation laws.

The City's vehicle replacement program will be suspended for an additional year. This will be the fourth year that no additional funding has been budgeted to replace the City's non-public safety fleet.

It is essential to upgrade existing technology to preserve the investment that the City has already made. To that end, the PeoplesSoft HR Payroll system will be upgraded at a cost of \$1.5 million. This will assure continued support to the automated payroll system and provide all the necessary upgrades to conform with federal and State regulatory changes.

Transportation and Aviation

The importance of coordinating the City's transportation and aviation services has been evidenced by initiatives such as the Coleman Avenue/Interstate 880 interchange, Highway 87, airport-area traffic surveillance and management and Guadalupe River trail planning. Beyond specific projects, however, the air and surface transportation services provided by the City of San José focus on similar outcomes. Fundamentally, each service strives to facilitate the movement of people and goods in a manner that both strengthens our economy and enhances quality of life for San José residents. For both surface and air transportation, pursuing these potentially competing goals requires a continual sensitivity to neighborhood impacts, and a commitment to mitigating such impacts.

Several areas have been identified for evaluation and development of coordinated initiatives between transportation and aviation:

- Integrating neighborhood presentation material and cross-training staff;
- Identifying additional in-sourcing opportunities;
- Reviewing inter-modal traveler support systems; and,
- Leveraging maintenance management practices.

Throughout the transition period, we will build on areas of synergy while maintaining distinctions where appropriate. The following sections summarize key issues and strategies for Surface Transportation and Air Transportation, respectively.

Surface Transportation — To continue to meet the basic needs of residents during this sustained economic downturn, the Surface Transportation adjustments for 2005-2006 include difficult tradeoffs between preventative maintenance, long-term pavement rehabilitation, planning, and technology-based programs.

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Transportation and Aviation (Cont'd.)

Approved priorities structure services around performance outcomes to minimize customer impacts and to focus on safety. Where possible, fees were increased, and staffing levels were reduced to correspond with the current levels of funding available for CIP programs and projects. In total, 22 positions are eliminated as part of more than \$2.9 million in approved reductions.

This will result in a decreased ability to perform preventive maintenance on pavement and landscaping, which will exacerbate conditions over the next several years until funding and staffing levels can be restored. Reductions in capital program funding, including system improvements for the street network, have required further realignment of staff. Other specific areas of expenditure reductions include transportation operations, traffic signal maintenance and neighborhood traffic services. An approved reduction will eliminate one team (seven positions) from the Police Department Traffic Enforcement Unit, reducing staffing in that unit by 12%. This adjustment will impact response and investigation of non-fatal traffic accidents.

In the interest of improving pedestrian safety in San José, this budget uses capital funds to install countdown signals, red light enforcement devices and crosswalk enhancements at critical intersections throughout the City. Capital funds will also be used to replace incandescent traffic signal lamps at 400 intersections with energy efficient LED bulbs, saving an estimated \$290,000 annually. To assist with signal lamp retrofitting and the installation of pedestrian safety devices, two new capital-funded electrician positions will be created for one year.

While the 2005-2006 Adopted Operating Budget adjustments will allow the CSA to continue targeted improvements to City transportation assets, residents will notice cuts in pavement maintenance and tree services. In addition, a 50 percent reduction in sidewalk repair grants was approved. Cleaning of the downtown transit mall will also be cut in half, with remaining resources focused on high use areas. This reduction is expected to decrease the percentage of customers rating services as good or better from 78 percent in 2004-2005 to 45 percent in 2005-2006.

A portion of this shortfall may be made up by State Proposition 42 and federal transportation legislation, pending final passage of those budgets. At the Santa Clara County level, a new sales tax measure proposal with allocation to cities provides some hope of additional funding for critically needed street maintenance. In addition, Strong Neighborhoods Initiative staff is looking at opportunities for federal grant funding for neighborhood transportation improvements identified as neighborhood priorities. However, available transportation funding will still be nowhere near levels needed to fully maintain the street and landscape infrastructure.

Air Transportation — The Norman Y. Mineta San José International Airport plays a pivotal role in the local and regional economy, and is a critical component of the City's Economic Development Strategy. San José's competitiveness as a global business center and travel destination is clearly linked to the City's ability to develop and operate a world-class airport. While long-term goals for major facility improvements at the Airport remain a priority, the sustained economic downturn challenges our ability to realize the Airport's potential in the near term. Since September 11, 2001, the Airport has experienced a serious decline in passenger traffic to levels similar to 1998-1999, roughly a 22% drop from the 2000-2001 high of 13.9 million annual passengers. While passenger

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Transportation and Aviation (Cont'd.)

traffic has recently shown some indication of positive growth, only a modest increase is expected during 2005-2006.

The City is now embarking on construction of the new North Concourse. The North Concourse will provide the space needed to meet federal security requirements for the permanent installation of explosive detection equipment and for an automated in-line baggage screening system. These improvements will enhance customer service and reliable security processing while reducing ongoing costs for temporary facilities. The timing of future facility improvements, including the South Concourse and the Central Terminal, will need to be re-evaluated based on economic conditions in the years to come.

We are also investing in the airport's future through the recent acquisition of the FMC property, which provides additional parking, lease space, and off-airport construction areas.

In 2005-2006, costs will be managed through \$3.2 million in strategic expenditure reductions. The savings are largely related to administrative reductions and service efficiencies, while allowing for targeted investments in key areas such as air service development and technology support. At the same time, enhanced customer amenities will continue to be pursued, such as concession improvements and development of a "cell phone lot" for motorists wishing to wait for a call from incoming passengers prior to moving to the curbside for pickup.

These strategies place demands on staff to be innovative and creative in meeting the needs of our customers so that they will continue to choose San José as their airport of choice. Cost management and control will continue to be a priority for the organization, and is vital so that the CSA can continue to be responsive to our customers, the community, and our partners. Customer service measures, such as improved signage, interim facility modifications, and beautification of construction areas will help mitigate the disruption caused by aging infrastructure and intensive construction.

As noted above, business development resources will be focused on attracting new air service and expanding the City's incumbent air carriers, including the addition of new destinations to JetBlue and Southwest Airlines such as Boston and Chicago-Midway respectively. In an increasingly global business environment, the enhancement of air service to key trade centers, both domestic and international, is an important economic development objective.

Finally, the City's commitment to operating the Airport as a good neighbor will continue. The Airport Neighborhood Services Group will continue to perform outreach in the community by providing information and receiving input on proposed development and operational changes at the Airport.

Environmental and Utility Services

Residential recycling and solid waste collection, neighborhood street sweeping, capture of stormwater runoff, and the collection and treatment of residential and commercial wastewater are the major services provided by the Environmental and Utility Services CSA. In addition, water

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Environmental and Utility Services (Cont'd.)

service is provided to the high-tech and high-growth residential areas of San José. These programs protect the environment and support the City's economic development strategy. They assist the City's strong neighborhoods programs by: 1) funding neighborhood clean-ups; 2) enforcing parking restrictions to ensure streets are swept more thoroughly, 3) reducing localized ponding through storm pump station improvements and repairs to curbs and gutters; and, 4) helping to address other neighborhood priorities by scheduling storm and sanitary sewer work in tandem with other street improvements. While the economic downturn has had a relatively limited impact on revenues for this CSA when compared to those funded by General Fund dollars, stricter regulatory requirements and increased fuel cost for contractual service providers continue to affect the cost of delivering these programs. In addition, an aging utility infrastructure translates into increased maintenance, rehabilitation, and replacement costs.

Since the Environmental and Utilities CSA has been less directly affected by the economic downturn, it is recommended that this CSA continue to hold necessary positions vacant to provide opportunities for employees displaced from other CSAs.

A third of the storm sewer pump stations throughout San José are over 40 years old and require significant rehabilitation. Funding of \$500,000 will be used to replace or rehabilitate aging storm pump stations, reducing the risk of localized flooding in portions of the City. A \$500,000 increase to the Storm Capital Fund will support the City's Strong Neighborhood Initiative by allocating dollars for neighborhood storm drainage improvements to reduce localized ponding usually caused when stormwater pools due to raised or depressed curbs and gutters.

Another adjustment will expand neighborhood parking enforcement on street sweeping days by posting signs on an additional 40 miles in targeted areas at a cost of \$240,000. This will be the third year of a multi-year strategy to keep neighborhood streets cleaner and prevent debris from polluting local creeks by enabling street sweepers to clean more thoroughly along curbs. Three new stormwater pump stations (Rincon II, Highway 87 & Taylor, and Airport) will require funding for operation and maintenance in 2005-2006. Funding of \$236,209 was approved to address these needs.

The Regional Water Quality Board is imposing new requirements on the City to prevent pollutants from entering into the storm sewer system from future large land developments. Funding of \$364,000 was approved to add an Engineer in Environmental Services, a Planner II in Planning, Building and Code Enforcement, an Associate Engineer and 0.5 Program Manager in Public Works, and for data base improvements. These additions will be required to implement the changes imposed by the new National Pollutant Discharge Elimination System (NPDES) permit requirements. This work will be closely coordinated with the Community and Economic Development CSA.

Energy supply, reliability and costs continue to be a concern. As part of the Sustainable Energy Policy, San José continues to pursue energy efficiency in City operations, encourages renewable and clean energy use, and promotes energy efficiency in the community. The Silicon Valley Energy Partnership (SVEP), a collaborative between the City and PG&E, is proving to be highly successful at helping Silicon Valley businesses reduce their operating and maintenance energy costs. Through

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Environmental and Utility Services (Cont'd.)

this program, more than 200 San José businesses will receive rebates for installing energy efficient equipment in the coming year.

This kind of regional partnering will be even more critical across this CSA's core services in the coming fiscal years, particularly in continuing to address issues related to land development, water supply availability, and watershed protection.

Public Safety

As noted earlier, no area of public service is more essential to the public welfare than public safety, and the services in this CSA remain the City's highest priority. The magnitude of the shortfall facing the City and the fact that this CSA represents 2/3rds of all General Fund personal services costs dictates that not even Public Safety can be immune to the need for cost-saving proposals. In 2004-2005 preserving essential emergency services was accomplished mainly through redeployments from non-emergency response resources, reductions in certain specialty units, and implementation of various cost-saving measures that had limited impact on high priority service delivery. Following this action, 25 sworn positions in non-patrol duties frozen in 2004-2005 were eliminated in 2005-2006.

For 2005-2006, the Public Safety CSA strategy will continue to focus resources on providing essential emergency services in a timely manner. In accordance with this strategy, the elimination of one traffic team in the Police Department is included in the Transportation CSA section of this document. This action reduces the Police Department's Traffic Enforcement Unit from eight teams to seven teams. This reduction is expected to impact response and investigation of non-fatal accidents.

The CSA has initiated efforts towards consolidating grant-writing resources and will continue to explore other opportunities to consolidate capital project management and public safety education functions. A one-time allocation (\$941,000) will fund the accreditation process for new Firefighter-Paramedic recruits. Increases in various police fees have been included to maintain cost recovery levels. The CSA is expected to continue to receive some administrative support funds from the Urban Area Security grant from the Federal government. These funds will continue to reimburse the cost of managing this grant program for the San Francisco Bay region in 2005-2006 so that the City's General Fund will not be used.

It should be noted, however, that with its 2005-2006 approved funding level, the Public Safety CSA will:

- Continue to provide essential emergency services in a timely and effective fashion;
- Continue to meet EMS paramedic contractual requirements;
- Maintain and strengthen school partnerships related to gang and drug activity and crisis management;
- Continue to protect the health and safety of Public Safety personnel;
- Move forward with Bond projects that do not adversely affect operating expenditures;

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Public Safety (Cont'd.)

- Continue to explore opportunities for public outreach and training to make residents more capable of maintaining their individual safety;
- Provide Fire Special Operations response for incidents with specific response needs such as urban fire and rescue, high rise operations, hazardous materials incidents, aircraft responses, wildland fires, etc;
- Effectively investigate arson fires and aggressively pursue, apprehend, and prosecute suspects in these incidents;
- Continue to use grant funding to pursue inter-agency communications projects, in compliance with Department of Homeland Security directives; and
- Continue to put San José in the forefront of Homeland Defense in Northern California by continued active participation in the FBI's Terrorist Task Force and strong linkage with Homeland Defense.

CAPITAL BUDGET HIGHLIGHTS

Capital Budget Overview

The 2005-2006 Adopted Capital Budget and the 2006-2010 Adopted CIP are each lower this year than last. The Adopted CIP has been reduced by 40% to \$2.1 billion, and the 2005-2006 Adopted Capital Budget reflects a 5% reduction to \$1.17 billion. These decreases are due almost entirely to a significant re-phasing of the Airport expansion, related to the continued weakness in the air travel market. Despite the Airport-related decrease, the Adopted CIP still provides over \$2 billion over the next five years, continuing the *Decade of Investment* that is transforming much of the City's infrastructure. Major improvements continue in the City's parks, community centers, libraries and public safety facilities, primarily as a result of voter-approved bond measures that will generate a total of \$599 million for these purposes. The construction of the North Concourse at the Airport represents a significant expansion of this facility and addresses new federally mandated security requirements. Substantial investments in the City's utility infrastructure are also underway, designed to ensure the continued safe and efficient operation of these facilities and the ability to address future growth. The construction of the new City Hall is also near completion and City staff has already relocated to the City's new corporate headquarters.

The three major voter approved General Obligation Bond measures approved in 2000 and 2002 continue to be utilized to upgrade and replace public safety facilities, parks, community centers and libraries. In November 2000, General Obligation Bond measures were approved to support library projects (\$212 million) and parks projects (\$228 million). In addition, City public safety facilities are undergoing major renovations and expansions as a result of the voter approved Public Safety Bond Measure in 2002 that authorized the issuance of General Obligation Bonds in the amount of \$159 million for public safety projects. This Adopted CIP allocates a combined \$403 million from these sources to continue building and improving library, parks and public safety facilities. Significant capital investments in the City's utility infrastructure are also programmed in this CIP, including continued progress on the \$89 million Reliability Improvements Project at the Water Pollution Control Plant that was awarded in February 2005, and the expansion of the water and sanitary sewer systems into the Edenvale and North Coyote Valley areas.

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Capital Budget Overview (Contr'd.)

The Airport Capital Program remains the largest single component of the overall CIP, despite the sharp reductions from last year. While the prolonged slump in local airport activity has led to an approved re-phasing of the timing of the Master Plan build-out, the funds dedicated to bringing significant improvements to Mineta San José International Airport still represent 40% of the 2005-2006 Capital Budget and 38% of the Five-Year CIP. In the near term, the focus of this program will be on compliance with federal security mandates. The most significant of these security projects is the North Concourse Building, which includes a permanent automated in-line explosive detection system and associated security screening space. The major non-security projects have now been deferred beyond the Five-Year CIP. The schedule for the Airport Master Plan build-out, it should be emphasized, remains dependent on market demand and may be adjusted further in the future.

CIP Challenges

The City continues to face major challenges in the development of its Capital Improvement Program. The most significant of these are: insufficient funding to address all capital infrastructure needs; escalating construction costs; and identifying General Fund resources to address operating costs for new facilities.

Insufficient Funding to Address All Capital Infrastructure Needs

While the City has made excellent progress over the past five years addressing some of our most significant infrastructure needs, other major areas remain in which the available funding for capital improvements is insufficient to address critical needs. With much of the City's infrastructure built in the 1960s and 1970s, the number of aging facilities that require significant renovations or replacement is considerable. The General Obligation Bonds approved for the parks, community centers, libraries and public safety facilities are helping to address the major needs in those specific areas. However, in other areas, long-term solutions for maintaining and replacing assets have not yet been identified.

A prime example is the Traffic Capital Program where available funding over the next five-year period falls well below even the minimum level necessary to address the City's basic transportation systems needs. For instance, the street maintenance funding in the Adopted Capital and Operating Budgets totals \$11.2 million in 2005-2006, well below the \$30 million needed annually to maintain this system in good condition. Pending the identification of additional local funding for this program, the Administration will continue to actively seek federal and State funds.

Similarly, for the municipal facilities that rely on the General Fund for capital improvements, there are persistent funding shortages that make significant investments in the infrastructure extremely difficult given the many demands on this limited resource.

Escalating Construction Costs

In addition to the overall shortfall in funding discussed above, we are currently experiencing the negative impact of escalating construction costs driven primarily by the rising costs of raw materials. In the Library Capital Program, for example, moderate reductions in the square footage of several Bond-funded library branches were approved to keep the projects within budget. Similarly, in the Water Pollution Control Plant (WPCP) Capital Program, Council approved the reprogramming of

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CIP Challenges (Cont'd.)

Escalating Construction Costs (Cont'd.)

several projects, including the Electrical Reliability Improvements project, due to higher than anticipated construction bids received for the \$89 million WPCP Reliability Improvements Project. In the Public Safety Capital Program, substantial increases to the bond-funded fire station projects were necessary as a result of both escalating construction costs and changes in project scopes to meet revised fire station requirements. These increases were offset by a significant reduction in the funding for the Fire Training Center.

Identifying General Fund Resources to Address Operating Costs for New Facilities

During the *Decade of Investment* that is transforming the City's capital infrastructure, a heightened focus on project delivery has supported the completion of a record number of capital projects. However, the large number of project completions brings with it a major challenge – identifying the resources necessary to operate and maintain the new facilities at a time when overall reductions in General Fund resources have forced reductions in existing City services across the board.

In response to this challenge, the City Council has previously approved the deferral of a number of capital projects with significant General Fund operating impacts. In developing the 2006-2010 CIP, the Administration again reviewed all projects scheduled for completion in the next few years to identify those that would create significant new operating costs, and we were not able to identify a large number of additional deferrals to recommend. Due to the strategy employed by the Library, for example, staff and collections from libraries under construction have all been phased in a manner intended to minimize additional operating expenses during the construction process, so no significant additional deferrals were identified. In the Parks and Community Facilities Capital Program, the majority of projects with considerable operating and maintenance costs were deferred as part of the last CIP process. In this and future operating budgets, a primary strategy was initiated to mitigate the operating and maintenance costs for facilities scheduled to open over the next five years. This involves taking a comprehensive look at all parks facilities to determine which might be considered for closure based on age or because they duplicate services found in the same geographical proximity.

In the Public Safety Capital Program, a combination of an alternative staffing model that would redeploy existing staff to the new stations on a temporary basis and limited project deferrals were approved in the 2006-2010 CIP to reduce operating costs. These strategies are expected to generate approximately \$5.9 million in General Fund savings over the next five-year period. However, even with these savings, the total price tag for the new fire stations is expected to reach \$7.5 million by 2009-2010.

In the Traffic Capital Program, a concerted effort was made to program investments that would minimize the addition of significant operating and maintenance costs to the General Fund. The number of programmed new traffic signals has been reduced and funding to construct new streetlights has been eliminated. Instead, funding has been invested in an LED retrofit project for traffic signals that should save \$290,000 annually by converting incandescent bulbs to more energy efficient LEDs, and in a technology review project that will evaluate how City streets may be lighted more cost effectively.

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CIP Challenges (Cont'd.)

Identifying General Fund Resources to Address Operating Costs for New Facilities (Cont'd.)

In summary, funding the additional operating and maintenance costs associated with projects contained in this program remains a major challenge. As detailed below, General Fund operating costs for facilities included in the 2006-2010 CIP will total \$2.7 million in 2006-2007 and climb to \$20.8 million by 2009-2010. (Operating budget adjustments for facilities scheduled to come on line in 2005-2006 were considered in the development of the Adopted Operating Budget.)

Projected General Fund Operating and Maintenance Costs

<u>Project Title</u>	<u>2006-2007</u>	<u>2007-2008</u>	<u>2008-2009</u>	<u>2009-2010</u>
Communications Projects	\$ 31,000	\$ 31,000	\$ 31,000	\$ 31,000
Fire Facilities	564,000	2,952,000	6,742,000	7,479,000
Library Facilities	1,831,000	2,350,000	3,848,000	7,451,000
Parks Facilities	326,000	862,000	3,351,000	4,785,000
Parks Facilities-Other Agencies	65,000	225,000	235,000	249,000
Police Facilities	26,000	371,000	716,000	752,000
Traffic Projects	(188,000)	(131,000)	(74,000)	(34,000)
Traffic Projects-Other Agencies	45,000	46,000	49,000	50,000
Total	\$ 2,700,000	\$ 6,706,000	\$ 14,898,000	\$ 20,763,000

Capital Program Overview by City Service Area

Each of the City's 15 capital programs has been aligned to a particular CSA. Following is a brief discussion of significant issues and projects included in the Adopted CIP presented by CSA.

Aviation Services

The Adopted Airport Capital Program represents a significant change from the program presented in the 2005-2009 CIP. Acknowledging the reality of the continued weakness in the economy and air travel market, this Airport CIP is \$1.3 billion or 63% lower than the prior CIP. The immediate focus of the Adopted CIP is the implementation of the security-related projects, the largest of which is the North Concourse Building. In the CIP, \$194.4 million was approved to continue the North Concourse Project, which includes baggage screening equipment, security screening space, ticketing and baggage claim operations, holdrooms, and jet bridge gates. These improvements provide the permanent response to the federal Aviation and Transportation Security Act requirements. In addition to the North Concourse Project, \$54.6 million is programmed in the Adopted CIP for a number of other security projects, including the Airline Maintenance Facility, Central Plant Expansion, Air Cargo Screening, Security ID Display Area Improvements, Belly Freight Facility, and various infrastructure improvements, refurbishments and demolitions.

Non-security projects, including the South Concourse Building, the Central Terminal Building, and double level roadway, were deferred outside the five-year CIP. The implementation of these major non-security related projects will be driven largely by market conditions, as well as other factors, such as service level impacts on operations and facility functionality and the amount and availability

2005-2006 ADOPTED BUDGET MESSAGE

Capital Program Overview by City Service Area (Cont'd.)

Aviation Services (Cont'd.)

of future federal funding. As a result, it should be noted, these schedules may in the future need to be delayed or accelerated in response to changes in these variables.

The Adopted CIP also includes \$28.6 million to continue the acoustical treatment of approximately 1,200 eligible properties and extending the program to more areas south of the Airport.

Economic and Neighborhood Development

The Economic and Neighborhood Development CSA includes the Developer Assisted Capital Projects Capital Program. This program reimburses residential developers for construction of major City streets and encourages the undergrounding of existing overhead utilities. Reimbursements to developers are scheduled for the Communications Hill and the Dairy Hill projects. In the Underground Utility Program, projects in the following areas are programmed in the CIP: Park/Naglee; Saratoga Avenue; Jackson/Taylor; Stevens Creek; Camden Avenue; and Evergreen Park.

Environmental and Utility Services

The Environmental and Utility Services CSA includes the Sanitary Sewer System, Storm Sewer System, Water Pollution Control and Water Utility Capital Programs.

Sanitary Sewer Capital Program: The objectives of this capital program are to rehabilitate large diameter sanitary sewers, reduce water inflow and infiltration in sanitary sewers, improve local neighborhood sewers, extend sanitary sewers to new development areas, and incorporate recommendations from the San José North Interceptor Facility Plan Report. Major projects in the Adopted CIP include the completion of the Edenvale Sanitary Sewer, Phases VI and VII of the Fourth Interceptor, and Phases VB and VIB of the 84-Inch RCP Interceptor. In addition, several neighborhood sewer improvement projects are programmed in the East San Jose, Forest-Rosa, Hobson-Walnut, Monterey-Riverside, Rosemary and Willow-Union neighborhood areas.

Storm Sewer System Capital Program: The purpose of the Storm Sewer System is to collect storm water, separate it from the Sanitary Sewer System, and convey it to nearby creeks and rivers. In accordance with the City's General Plan, the goal of the Storm Sewer System Program is to reduce the risk of drainage-related surface damage and to protect the quality of storm water runoff. Continuing the annual moderate rate increases that were approved by Council in June 2002, a three-year rate strategy was approved by City Council in June 2005 to increase the Storm Sewer Service Charge rate by 4.5% annually. This CIP assumes that 4.5% rate increases will continue in all years of the CIP, building in predictable, measured adjustments in service charges to continue a modest investment in the capital infrastructure and ensure the fiscal health of the Storm Sewer Operating Fund.

With the limited resources currently available, the major storm drainage improvement projects programmed in the Adopted CIP are as follows: Albany-Kiely, Phase II, III and IV; Storm Pump Station Replacements; Willow Glen-Guadalupe, Phase II and III; Reserve for Alma Storm Drain; and Chateau Drive Storm Drain Improvement, Phase I and II.

2005-2006 ADOPTED BUDGET MESSAGE

Capital Program Overview by City Service Area (Cont'd.)

Environmental and Utility Services (Cont'd.)

Water Pollution Control Capital Program: The San José/Santa Clara Water Pollution Control Plant (WPCP) is a regional wastewater treatment facility serving eight tributary sewage collection agencies, including municipalities and sanitary sewer districts. This CIP focuses on preserving the WPCP infrastructure and capacity improvement projects. In order to maintain the program represented in this document, this CIP assumes rate increases will continue annually beyond the three-year 4.5% rate increase that was approved by Council in 2004 for the Sewer Service and Use Charge Fee. These increases will be necessary to fund major capacity improvement projects and critical projects at the Plant.

The major projects programmed in the Adopted CIP include: Plant Reliability Improvements (\$2.6 million) to complete this \$89 million project that will improve the Plant's ability to handle wet weather flows and improve the reliability of several of the Plant's critical systems such as headworks, filtration and major pumping stations; Plant Electrical Reliability (\$17.0 million) to perform major upgrades and replacements of electrical systems; and Revised South Bay Action Plan (\$22.4 million) to complete the South Bay Water Recycling (SBWR) facilities in Santa Clara and Milpitas, the extension of a recycled water transmission line to serve the planned Metcalf Energy Center in South San José and the new City Hall, and to fund future recycled water improvements as funding permits.

Water Utility System Capital Program: The San José Municipal Water System provides water utility service to approximately 25,000 customers (approximately 100,000 residents) in five areas within the City of San José: Evergreen, North San José, Alviso, Edenvale, and Coyote Valley. Major projects in the Adopted CIP include: security improvements at various system facilities; rehabilitation and replacement projects (Edenvale Well #13 Rehabilitation, Water Valve Rehabilitation, Villa Vista Reservoir Rehabilitation, Reservoir System Seismic Retrofit, and Norwood Pump Station Replacement); and System Development Projects designed to provide more capacity or better coverage (Nortech Parkway East Loop Main, the North First Street Parallel Main, the Edenvale Well #4, and funding to start the Montague Turnout).

Public Safety

The objective of the Public Safety Capital Program is to provide, maintain and improve facilities and equipment that support the delivery of effective emergency services to residents and visitors. The construction of a new police substation, four new fire stations including a developer-funded Communications Hill Fire Station, and the relocation of six existing fire stations will provide the infrastructure to help meet this goal.

The major investments in Public Safety infrastructure included in this CIP are possible only because the voters in San José supported investments in these facilities. On March 5, 2002, 71.7% of voters approved Measure O, the "9-1-1, Fire, Police, Paramedic and Neighborhood Security Act" (Neighborhood Security Act Bond Measure). This bond measure authorized the City to issue General Obligation Bonds in an amount not to exceed \$159 million to fund both Police and Fire Department capital improvements.

All of the projects funded by the Neighborhood Security Act Bond are scheduled to be underway during this five-year period. These projects include the construction of a South San José Police

2005-2006 ADOPTED BUDGET MESSAGE

Capital Program Overview by City Service Area (Cont'd.)

Public Safety (Cont'd.)

Substation, three new fire stations, four community policing centers, and a driver safety training facility. The program also includes the relocation of six fire stations, the remodeling of 17 fire stations and the 9-1-1 Communications Dispatch Center, and renovations to the existing Fire Training Center.

As part of the budget deliberation process, major changes to the Public Safety Bond projects were brought forward as described in Manager's Budget Addendum #10 that was approved by the City Council with the final adoption of the budget. These changes increased the budget allocations for the new and remodeled fire stations by a total of \$15.8 million and the 9-1-1 Communications Center project by \$1 million, offset by a \$16.8 million reduction in the Fire Training Center project. These increases were necessary to address cost escalations and project scope changes to meet revised fire station requirements and to include the renovation of the Fire Dispatch function into the 9-1-1 Communications Center Project. The scope of the Fire Training Center project has been significantly downsized from a comprehensive renovation to a project that will incorporate improvements that address immediate facility needs only. In addition to the changes in project costs, a combination of an alternative staffing model that would redeploy existing staff to the new stations on a temporary basis and limited project deferrals to mitigate the operating and maintenance impact of the new fire stations were approved in the 2006-2010 CIP.

Recreation and Cultural Services

The Recreation and Cultural Services CSA includes the Library and Parks and Community Facilities Capital Programs. These programs support the following CSA outcomes:

Library Capital Program: The City's library system is undergoing a major transformation as a result of the November 2000 voter-approved bond measure that approved the issuance of \$212 million in General Obligation bonds to improve the branch library system over a ten-year period. This bond measure provided funding for the reconstruction or replacement of 14 of the 17 existing branches and the construction of six new branches in unserved neighborhoods. Listed below are the new and renovated branches that will be completed over this five-year period. It should be noted that the West Side Branch Project was accelerated by a year in order to align the completion schedule with the District 6 Multi-Service Community Center, allowing the potential development of a joint library/community center project.

New Branches

- West Side
- Edenvale

Renovated Branches

- Almaden
- Calabazas
- Cambrian
- East San José
- Educational Park
- Evergreen
- Hillview
- Joyce Ellington
- Pearl
- Rose Garden
- Santa Teresa
- Seventrees
- Willow Glen

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Capital Program Overview by City Service Area (Cont'd.)

Recreation and Cultural Services (Cont'd.)

The recently passed Library Parcel Tax replaces the sunsetted Benefit Assessment District in 2005-2006. The Library Parcel Tax was placed on the ballot in November 2004. Over the next ten years, starting in 2005-2006, this revenue will provide similar levels of funding for the purchase of materials and automation as did the Benefit Assessment District. Roughly half of the total funding of \$16.1 million for new acquisition of books and materials will come from this source, supporting a targeted level of 200,000 acquisitions per year.

Parks and Community Facilities Capital Program: This program plans for and implements the acquisition, development, and protection of parks, recreation facilities, and open space to maintain a high quality of life in San José. The program is managed through the use of 17 funds, including 10 Council District funds, a City-wide fund for city-wide/regional facilities, a Parks Bond Fund, and five special purpose funds, as well as contributions from the General Fund.

Proceeds from General Obligation Bonds the Parks Bond Fund has provided a significant amount of resources to address capital needs in the City's various park facilities. On November 7, 2000, City voters approved Measure P, a \$228 million General Obligation Bond for park and recreational facilities improvements. This bond program will provide funding over a 10-year period to renovate 95 neighborhood park play areas, add a total of 164,000 square feet to nine community and senior centers, renovate 28 park restrooms, build two new sports complexes, expand the City's trail system at four locations, enhance four regional park facilities, including improvements and renovations at Happy Hollow Park and Zoo. The 2006-2010 Adopted CIP includes \$119 million for the construction of Bond projects. Over the course of this five-year CIP, six community centers will be renovated or built, two sports parks will be constructed, Emma Prusch Memorial Park will be renovated, significant progress will be made on the renovation and expansion of Happy Hollow Park and Zoo, and several City trails will be expanded.

To begin to accumulate the funds necessary to maintain the expanding infrastructure of parks, tot lots, trails and community centers in districts throughout the City, the Reserve for Strategic Capital Replacement, first introduced in the 2005-2009 CIP, was increased from \$25,000 to \$200,000 annually in each Construction and Conveyance Council District Fund.

Transportation Services

The Transportation Services CSA includes the Parking and Traffic Capital Programs.

Parking Capital Program: The Parking Capital Program's primary responsibilities are to maintain and improve existing facilities, upgrade and replace both on-street and off-street parking equipment, and develop parking facilities.

As part of the implementation of the San José Redevelopment Agency's (SJRA's) Strategy 2000 – Greater Downtown Strategy for Development, a Parking Management Plan was developed in 2001 to address both short-term and long-term parking needs. As a result of the changing environment since the Parking Management Plan was approved, last year the City Council/SJRA Board, in coordination with the Downtown Parking Board, directed staff to review the plan and track key economic and parking information. With this information, the Council approved a series of economic and parking demand triggers as a way to gauge changes in the local economy and to

2005-2006 ADOPTED BUDGET MESSAGE

Capital Program Overview by City Service Area (Cont'd.)

Transportation Services (Cont'd.)

initiate parking development at the appropriate time. During the 2005-2006 budget process, annual updates to the parking triggers and priorities were approved by the City Council based on the most recent data. While no new facilities are funded at this time, the Adopted CIP includes funding for the following: 2nd and San Carlos Garage Seismic Upgrade project; Phase II of the Parking Guidance System that will include roadway signs to direct motorists to the parking facilities; replacement of the Parking Revenue Control System at several garages and lots; and ongoing facility improvements.

Traffic Capital Program: The mission of the Traffic Capital Program is to implement a safe, efficient, and environmentally sensitive surface transportation system, consistent with the goals and policies of the City's General Plan. In the 2006-2010 Adopted Traffic CIP, \$210.7 million is allocated for the purposes of expanding and enhancing the transportation system. These resources are programmed to ensure that the transportation system supports the economic competitiveness of San José and provides residents with safe and attractive street facilities in their neighborhoods.

The investments approved as part of the 2006-2010 Adopted CIP include funding for the build out of the major street network (\$21.6 million); enhancements to the environment (\$1.7 million); maintenance activities (\$29.9 million); an array of operations and safety projects at the neighborhood level, including traffic calming, bicycle and pedestrian facilities, and new traffic signals (\$40.5 million); rehabilitation projects (\$13.7 million); funding to support the City's contribution to regional highway and transit systems (\$7.1 million); and planning and engineering for local and regional projects (\$26.9 million).

During 2004-2005, the Santa Clara Valley Transportation Agency (VTA) updated its 30-year regional transportation master plan referred to as Valley Transportation Plan 2030 (VTP 2030). The plan includes an inventory of projects eligible for future regional transportation grant funding. To support the City's Council-adopted priorities in the VTP 2030, a reserve in the amount of \$20.1 million was approved to begin to provide necessary local matching funds for eligible projects.

As part of the General Fund budget balancing plan, the transfers from the Construction Excise Tax to the General Fund total \$6.8 million as part of this CIP. In 2005-2006, the transfer of Construction Excise funds to the General Fund totals \$5.3 million.

Strategic Support

The Strategic Support CSA includes the Civic Center, Communications, Municipal Improvements, and the Service Yards Capital Programs.

Civic Center Capital Program: The Civic Center Capital Program is responsible for constructing the new City Hall and associated parking facilities. The new City Hall includes approximately 530,000 square feet of office and public space on a 4.9-acre site located on the south side of East Santa Clara Street, between 4th and 6th Streets. Major components of this project include an 18-story office tower, a council chamber wing, an open public plaza with a rotunda, plus a 372-vehicle underground parking garage to serve the visiting public and some staff. The new facility was occupied on schedule beginning in mid-2005, with the off-site garage scheduled for completion in spring 2006. The offsite garage had been deferred by one year as a result of a lawsuit. The 2006-2010 Adopted CIP includes funding of \$10.8 million to complete the construction project. This

2005-2006 ADOPTED BUDGET MESSAGE

Capital Program Overview by City Service Area (Cont'd.)

Strategic Support (Cont'd.)

includes approved funding of \$4.0 million from the Project Contingency to address estimated close out and contractor claims costs. In addition, \$10.8 million is programmed in the Adopted CIP for furniture, technology, equipment and relocation to operate this facility. A total budget of \$45.25 million was allocated for these non-construction costs. However, the Administration is making every effort to reduce costs by at least 15% as directed by the City Council. Based on awards to date, savings of 15-20% (\$7-9 million) are anticipated.

Communications Capital Program: The guiding objective of the Communications Capital Program is the provision of reliable, necessary public and non-public safety-related communications equipment for all City employees that require this equipment for their jobs. A total of \$6.2 million is allocated in the Adopted CIP to replace and upgrade equipment. In addition \$815,000 is allocated to install additional police voting receivers and upgrade signal conditioning devices at existing radio sites. This project will increase radio coverage across adjoining police districts.

Municipal Improvements Capital Program: The General Fund typically supports the projects in this capital program. In the 2006-2010 CIP, such investments are very limited and include only funds rebudgeted from 2004-2005 to finish existing projects and the annual ongoing allocations for HP Pavilion Repairs (\$100,000), Fuel Tank Monitoring at City facilities (\$50,000); Methane Monitoring and Control (Landfill Projects-\$250,000); and Unanticipated/Emergency Maintenance (\$200,000). In addition, \$1.4 million in the Interim City Facilities Improvement Fund was rebudgeted for improvements to implement the Interim Space Plan for housing City employees that will not be relocating to the new City Hall.

Service Yards Capital Program: The objective of the Service Yards Capital Program is to maintain and improve the existing conditions at the Service Yards by implementing projects to reduce safety hazards, increase efficiencies, and provide necessary equipment and materials for operations. While ongoing funding is allocated to address general capital improvement needs, the majority of funding in this capital program is set aside for the Central Service Yard Phase II project. A revised and accelerated schedule, space plan and design for the Central Service Yard Phase II project was approved in the 2006-2010 CIP. The financing strategy includes the sale of commercial paper and bonds as well as the sale of the Main Service Yard. The project includes design in 2004-2005, construction beginning in 2005-2006 and ending in 2007-2008.

Continuing a General Fund budget balancing strategy approved in 2003-2004, \$1.8 million from the Service Yards Construction and Conveyance Tax Fund will be allocated to fund Central Service Yard Phase I Debt Service costs for 2005-2006. It is anticipated that the General Fund will resume responsibility for these payments after 2005-2006.

Measuring Capital Performance

A set of performance measures has been introduced to assess capital program performance based on schedule (cycle time), cost, quality, and customer satisfaction. These measures are designed to provide uniformity and consistency, provide clear and measurable outcomes, and to encourage CSA teams and departments to consider total requirements for service delivery, including capital facilities

2005-2006 ADOPTED BUDGET MESSAGE

Measuring Capital Performance (Cont'd.)

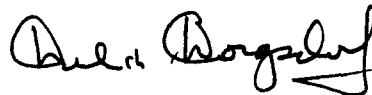
and assets. In this budget, one- and two-year performance targets, along with estimated performance results for 2004-2005, are presented for each of these performance measures.

CONCLUSION

This 2005-2006 Adopted Operating Budget successfully closed a \$58 million dollar shortfall with a combination of ongoing reductions and the strategic use of reserves and one-time dollars. The number of filled positions that were eliminated was minimized by the continued hiring freeze that successfully accumulated a large contingent of vacancies. The coordinated efforts of every City Service Area identified opportunities to be more efficient while reducing costs. However, after four straight years of declining revenues, the decisions placed before the City Council were difficult ones that will be felt by our residents. That is the unavoidable reality of our current economic climate. With the one-time solutions included in this Adopted Operating Budget, we can anticipate beginning next year's exercise with a shortfall somewhere in the range of \$63 million.

Given the unprecedented and enduring economic decline experienced over the past four years, the Administration believes the approved mix of reductions, one-time solutions, and use of reserves represents a sound approach to balancing the budget. We have maintained our commitment to provide essential services, meet the City's basic infrastructure requirements, and keep the City Council's commitment to neighborhoods. This is a plan that continues the sound financial discipline that has allowed us to successfully manage through the current economic downturn.

I want to express my appreciation to all of our dedicated City employees for their involvement and understanding, and to the City Labor Alliance, which has once again worked closely with the Administration as we moved through a very difficult budget season. I especially want to take note, again, of the thousands of employees who joined with the City's management team to forego raises this past year. And finally, I want to acknowledge the professionalism displayed by the City's Senior and Executive Staff, as well as the many other employees who made a direct contribution to the preparation and production of this document and to express my sincere appreciation for their hard work.



Del D. Borgsdorf
City Manager